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BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

The Impact of the 2017 Tax Cuts & Jobs Act on the Investment Management Industry

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Introduction

At first glance, the 2017 Tax Cuts and Jobs Act (TCJA) doesn't appear to be directed at the investment management industry. The focus on C corporation tax rates doesn't affect many RIAs, since most are structured as LLCs or S corporations. Many provisions in the TCJA pertain to things like expensing capital items or repatriating foreign income, neither of which are material to most asset management firms. In addition, the Qualified Business Income deduction (or QBI) is specifically excluded from investment management firms that are profitable above a certain level.

Regardless of intent, however, the tax bill has already had, and will continue to have, a tremendous impact on the investment management community that warrants considerable attention from partners at RIAs. We won't mince words – this tax bill is a blockbuster for the investment management industry.

Taken as a whole, the TCJA has already been especially beneficial to the RIA sector, as lower corporate tax rates have had a positive impact on equity markets, boosting AUM and earnings, which are now taxed at lower rates. Although most firms are still assessing the full impact of tax reform, the TCJA will likely impact capital management, M&A activity, and investments in technology.

This whitepaper is a compilation of thoughts gathered during in the early days of this new tax regime. We expect to learn more as the year rolls on, as the compliance and tax planning opportunities presented by the TCJA materialize and work through the system. We don't suggest that this text is an exhaustive list of all of the implications of the tax bill on the investment management industry, but herein we present what we think are the major issues that RIA partners should consider. Specifically:

- **The tax bill has made investment management firms worth more by:**
    - Driving up AUM
    - Improving RIA economics
    - Making RIA pre-tax cash flows worth more
- **However, the tax bill has less of an impact on tax pass-through entities because:**
    - The tax advantage of S corps and LLCs, relative to C corporation, is now muted
    - Many RIAs will not benefit from the QBI deduction
- **Your RIA's shareholder agreement probably needs to be revised because:**
    - Most buy-sell agreements value the business via formula
    - RIA valuation rules of thumb have been rendered obsolete by the TCJA
    - The change in RIA valuations is potentially so significant that it calls into question the use of formula agreements entirely
- **The tax bill may have a mixed impact on asset manager M&A because:**
    - Higher valuations will bring more sellers to the table, and buyers will feel more pressure to complete transactions
    - Internal succession, however, may be more difficult because individuals won't enjoy the same increase in after-tax cash flows as corporate buyers

Most RIAs Are Worth More Under the New Tax Law

The Tax Bill Has Driven Up AUM (for Most)

Investment management revenue is a function of AUM, and the impact of the tax bill on valuations across a spectrum of asset classes is significant. While the impact of this on anyone who derives fee income from managing equities (fixed income shops are a different story) is clear, we don't think it's sufficient to just take the increase in market valuations at face; it's more useful to unpack the issue and consider why.

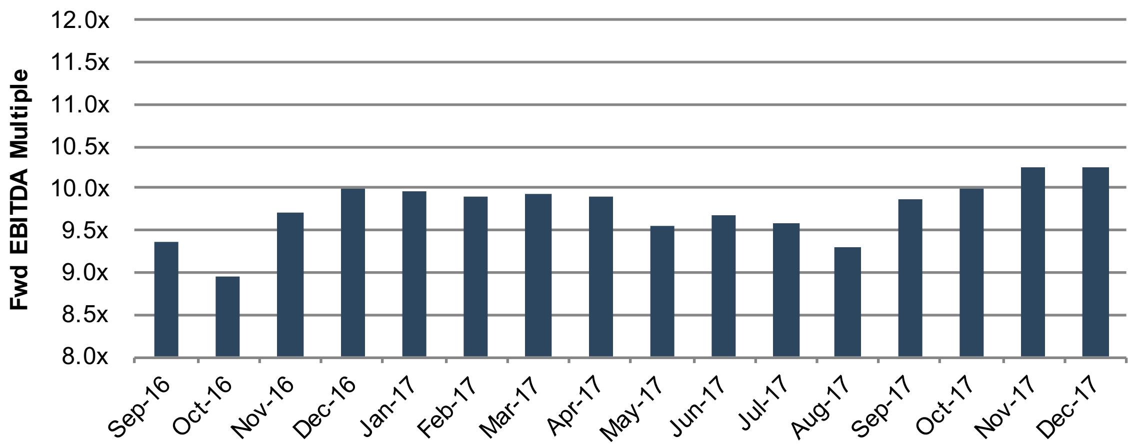
One of our colleagues here at Mercer Capital, Travis Harms, has researched the impact of the tax bill on valuation multiples across the broader market to consider not just the what, but also the why. Notably, Travis looked at the impact on pre-tax multiples, such as EBITDA, to interrogate whether or not a dollar of pre-tax cash flow is indeed worth more if it is less burdened with tax liabilities. We saw broad implications to his modeling exercise for the investment management community.

Travis pulled monthly forward EBITDA multiples for the S&P 1000 (ex financials). The S&P 1000 is a combined mid and small cap index, consisting of company #501 through #1500. As shown in Figure 1 on the next page, the median multiple for such firms was approximately 9.0x to 9.5x during the fall of 2016, when a Clinton administration, and tax status quo, seemed inevitable. By late 2017, the median multiple had expanded by almost a full turn, to about 10.3x.

Valuation multiples are, of course, a function of three factors: 1) cash flow, 2) risk, and 3) growth. To determine whether or not the change in multiples was indeed attributable to a change in tax rates, Travis investigated whether or not there had been an effective change in the cost of capital (risk) or an expectation of increased growth in earnings in Figure 2. The analysis inferred an aggregate cost of capital (supply side weighted average cost of capital, or WACC) for this equity basket in September of 2016 as an anchor point, and then observed changes in the cost of capital over the same period that resulted from a change in interest rates (holding the assumed equity risk premium constant).

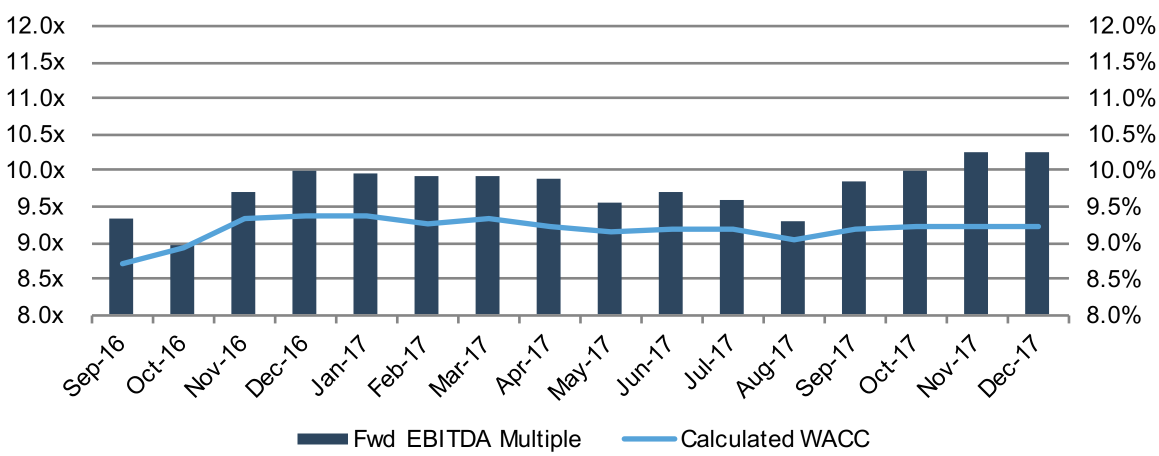
> Clearly, an increase in incremental cash flow from tax reform could impact likely favorably our capital management decisions, and that reflects both potential dividends and buybacks. And our plan is to – I mean, given the tax reform is basically three weeks old – our plan is to effectively reassess our latest capital management recommendations probably around mid-year once we kind of finalize the impact the tax reform is going to have on BlackRock. And there's going to be lots of additional guidance that's going to be forthcoming as well as making sure that we are looking at all of the balance sheet, if you will, opportunities that we have over the next several months, including more aggressively seeding and co-investing in new products.
>
> – Gary Shedlin, CFO, BlackRock

Figure 1



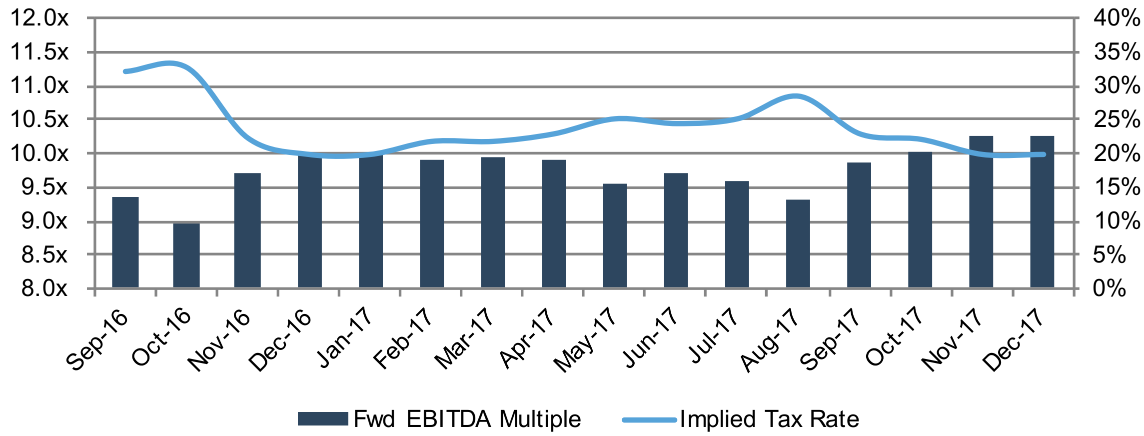
Forward EBITDA multiples for sample equity index (S&P 1000 ex financials) shows movement in multiples that appear to correlate with changes in the outlook for corporate tax reductions.

Figure 2



The risk-free rate (the interest rate on long dated treasuries) gapped up from close to 2.0% in September of 2016 to something on the order of 2.8% in December of that year, pushing the implied supply side cost of capital up to about 9.2%.

Figure 3



Using a DCF model framework to evaluate the impact of a change in tax expectations on valuation multiples, we can let the cost of capital float with interest rates and hold growth expectations constant, such that the change in valuation multiples can be attributed to the change in tax rates.

Travis then ran a DCF model on his equity basket, letting the tax rate float. His DCF model suggests that the market priced in effective tax rates of approximately 20% by the end of 2017 (Figure 3). Significantly, the early expectations for rate reduction seem to have waned a bit over the summer months as the Trump administration experienced a series of legislative failures. Also significant is that the model assumes there are no changes in the expected growth outlook for the companies in the sample basket, consistent with statements from the Federal Reserve suggesting no material uptick in GDP growth consequent from the tax bill. The model does not modify expected growth because there is no robust way to review earnings estimates for a broad array of companies on a month by month basis. Of note, Aswath Damodaran, a finance professor at NYU, thinks the tax bill may in fact increase the sustainable growth rate for U.S. companies.

The implication of this analysis is that market multiples reset upwards as a consequence of lower tax rates, and not because of changes in the cost of capital (which, with higher interest rates, would have caused multiples to fall), nor expectations of higher earnings growth (of which there is little evidence).

Put another way, the tax bill appears to have, indeed, inflated equity prices by reducing the tax burden on corporate profits. On one level, this is obvious, but the implications of this are interesting if it also suggests that current equity valuations are more sustainable than some believe. Perhaps pre-tax valuation multiples gapped higher, as they should have, and will remain higher than they would otherwise be, so long as corporate tax rates persist at these levels. That would certainly be good news for the asset management community.

The Tax Bill Has Improved RIA Economics (for Many)

The tax bill would seem to have improved returns for many subsectors of the investment management industry as well. If public market valuations gapped up 10% or so, would we expect to see nearly a 10% increase in assets under management across the equity space in the industry? More AUM means more revenue and more profitability? In short, yes, as we can show in the example in Figure 4.

Figure 4: Tax Bill Impact on RIA Returns
Sample Equity/Debt Manager ($000s)

	Before Tax Bill	After Tax Bill	*% change*
Equity AUM	$4,000,000	$4,400,000	*10.0%*
Debt AUM	1,000,000	1,000,000	*0.0%*
Total AUM	$5,000,000	$5,400,000	*8.0%*
Equity mgmt fee (bps)	65	65	*0.0%*
Debt mgmt fee (bps)	20	20	*0.0%*
Implied Total Revenue	$28,000	$30,600	*9.3%*
G&A	$4,200	$4,200	*0.0%*
Salaries	9,800	9,800	*0.0%*
Bonus Comp	4,200	4,980	*18.6%*
Total Expense	$18,200	$18,980	*4.3%*
EBITDA	$9,800	$11,620	*18.6%*
EBITDA margin	*35.0%*	*38.0%*	

The table above is self-explanatory. Assuming an RIA with $5 billion under management, of which 80% is managed equities and 20% is fixed income, a 10% increase in equity valuations would have a corresponding 8% increase in overall AUM, ceteris paribus.

If the same investment management firm realized fees of 65 basis points on equities and 20 basis points on fixed income, the leverage on the higher AUM attributable to equities would increase revenue a bit more than total AUM, or 9.3%. One potential problem with this aspect of the model is the assumption that clients with higher AUM balances won't pass-through breakpoints that will lower overall realized fees. For purposes of this example, however, we have assumed that the fee schedule isn't progressive with the increase in AUM.

> The fourth quarter open-end fund fee rate increased to 50 basis points from 48 in the prior quarter due to the impact of lower fund expense reimbursements as a result of the consolidation of service providers and an increase in average assets and higher fee equity products due to market appreciation.
>
> – Michael Angerthal, CEO, Virtus Investment Partners, Inc.

When we consider the leverage on operating expenses, however, things really get interesting. Higher AUM balances can lead to a correspondingly higher expense base if the increase comes from more accounts or assets that are more expensive to manage. In this instance, however, AUM is simply inflated because of market activity. We might not assume G&A costs would rise at all - nor would salaries, necessarily. Incentive compensation, however, would probably increase. Assuming bonus compensation to be 30% of pre-bonus EBITDA, we see an almost 20% increase in incentive compensation resulting from higher assets under management. Even with higher bonuses, however, total expenses only increase about 4%. The consequence of this is an increase in EBITDA of almost 20%, and a cash flow margin increase of three percentage points.

If you're an asset manager, your reality may (will) be different than our example. If interest rates continue to rise, our sample RIA might experience some diminution in income from managing fixed income portfolios. Clients may rebalance to maintain the same allocation between stocks and bonds. Clients are, on the whole, more fee sensitive than they once were, and may want some betterment of their fee schedule as a consequence of this moment of good fortune. And your staff will probably notice that there is more cash flow available for compensation. The market may bid up the cost of talent, or at least salaries and bonuses will increase more than we show here in an effort to "keep a good thing going." In any event, if your AUM increases nearly 10% and margins don't widen, it would be worth looking through your numbers some to assess why. The opportunity for a significant increase in profitability at many RIAs appears to be on the offer.

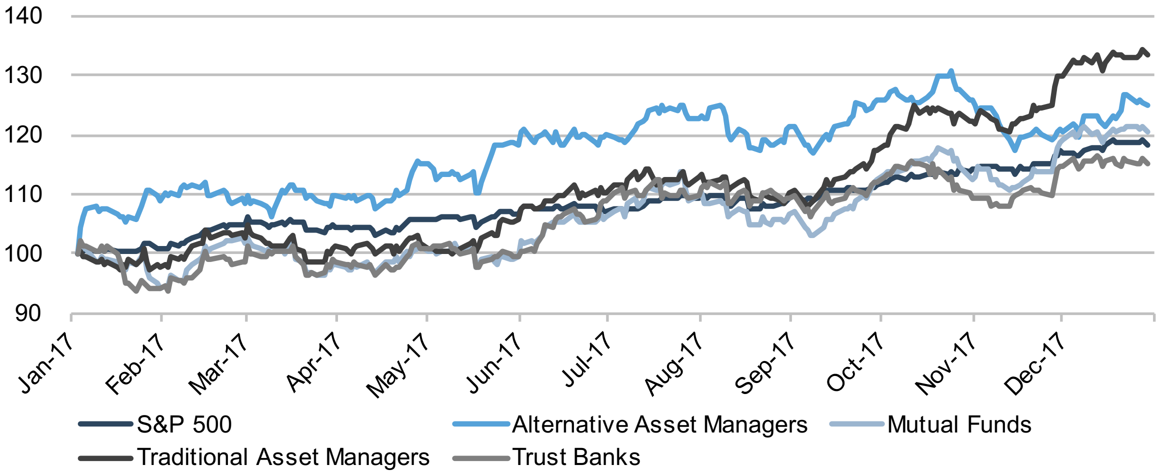
The Tax Bill Has Improved RIA Valuations (for Some)

Taking this one step further, RIAs may not only benefit from a repricing of market multiples of their clients' assets, but also of the value of their own returns. In our example firm, EBITDA increases 18.6% as a direct consequence of the tax bill. Valuations of RIAs would be expected to increase similarly, if there were no change in the valuation multiples for the RIAs themselves (Figure 5).

Figure 5: Tax Bill Impact on RIA Valuations
Sample Equity/Debt Manager ($000s)

	Before Tax Bill	After Tax Bill	*% change*
EBITDA	$9,800	$11,620	*18.6%*
Multiple	8.00	8.80	*10.0%*
Implied MVIC	$78,400	$102,256	*30.4%*
Implied AUM multiple	*1.57%*	*1.89%*	*20.8%*

Figure 6: Asset Manager Performance by Sector During 2017



Source: S&P Global Market Intelligence

If, however, appropriate multiples for investment management firms gap-up 10% like Travis Harms observed in the public equity market, then the combination of that plus improved profitability would produce a 30% increase in enterprise values for RIAs and a corresponding 20% expansion in the implied AUM multiple. The reason for the increase in RIA multiples is the same as the increase in the market basket of equities Travis studied: a dollar of pre-tax cash flow is worth more when the tax burden on that dollar is less (assuming no change in the cost of capital or earnings growth).

Figure 6 above illustrates how this double impact of the TCJA on RIAs (improving profitability plus expanding multiples) has played out in the public markets over 2017. Virtually all categories of publicly traded RIAs have outperformed the S&P 500 over 2017.

Whatever you do, don't run out of your office and tell your partners that your firm is worth 30% more than before the TCJA was passed. There are many variables that affect firm valuation – some discussed in this whitepaper, some we've left out, and some we probably haven't thought of yet. One issue in comparing movement in the public market multiples and private RIAs is that public companies are C corporations whereas many, if not most, private RIAs are some kind of tax pass-through entity like an S corporation or an LLC.

New But Unimproved: TCJA's Impact on Pass-through Entities

While the impact of the TCJA is mostly bullish for RIAs, the "rest of the story" involves the bill's impact on shareholder returns for RIAs structured as tax pass-through entities (S Corporations, LLCs, and Partnerships), for which the news is not so buoyant.

In essence, the TCJA took a good thing and made it not so good. The S corporation was a fairly brilliant innovation from the 1950s, allowing certain small businesses to benefit from the limited liability of being a corporation yet file their taxes as partnerships. S corporations (and LLCs) "pass-through" the tax liability on profits to their shareholders rather than pay one layer of tax at the corporate level on company profits and another at the shareholder level on dividends.

Why Many RIAs Are Structured as Tax Pass-Through Entities

Before the Trump Tax Bill, it often made sense to structure investment management firms as tax pass-through entities – usually S corporations or LLCs. As shown in Figure 7, given taxable income of, say,

Figure 7: Tax Treatment of S vs. C Corporations (Before New Legislation)

	Full Distribution	
	C Corp	S Corp
Pre-tax Income	$1,000	$1,000
times: Valuation Multiple	8.0x	8.0x
Indicated Value (Marketable Minority Interest)	$8,000	$8,000
Pre-tax Corporate Income	$1,000	$1,000
less: Corporate Income Taxes	35.0%	0.0%
After-tax Corporate Income	$650	$1,000
Pre-tax Corporate Income	$1,000	$1,000
times: Shareholder Tax Rate	0.0%	39.6%
Shareholder Pass-Through Tax Liability	$0	$396
Portion of After-tax (C corp) Income Retained	0.0%	0.0%
Retained Earnings	$0	$0
Corporate Distributions to Shareholders	$650	$1,000
less: Shareholder Pass-Through Tax Liability		(396)
After-tax Shareholder Distribution		$604
divided by: (1 - Personal Dividend Tax Rate)		23.8%
C Corporation Equivalent Distribution		$793
C Corporation Equivalent Dividend Yield	8.1%	9.9%

Assumes state tax rate of 0%.

Figure 8: Tax Treatment of S vs. C Corporations (Before New Legislation)

	50% Distribution	
	C Corp	S Corp
Pre-tax Income	$1,000	$1,000
times: Valuation Multiple	8.0x	8.0x
Indicated Value (Marketable Minority Interest)	$8,000	$8,000
Pre-tax Corporate Income	$1,000	$1,000
less: Corporate Income Taxes	35.0%	0.0%
After-tax Corporate Income	$650	$1,000
Pre-tax Corporate Income	$1,000	$1,000
times: Shareholder Tax Rate	0.0%	39.6%
Shareholder Pass-Through Tax Liability	$0	$396
Portion of After-tax (C corp) Income Retained	50.0%	50.0%
Retained Earnings	$325	$325
Corporate Distributions to Shareholders	$325	$675
less: Shareholder Pass-Through Tax Liability		(396)
After-tax Shareholder Distribution		$279
divided by: (1 - Personal Dividend Tax Rate)		23.8%
C Corporation Equivalent Distribution		$366
C Corporation Equivalent Dividend Yield	4.1%	4.6%

Assumes state tax rate of 0%.

$1 million, a C corporation would only have $650 thousand to distribute after paying federal corporate taxes at a rate of 35%. Even though the same $1 million of taxable income would likely be taxed at a slightly higher personal rate for S corporation shareholders, the after-tax distribution of $604 thousand would have a higher economic value when you consider S corp shareholders skip the dividend tax (paid at 23.8%) that would accrue to the C corporation shareholder. After grossing up the after-tax dividend to the S corp shareholder at the C corporation dividend tax rate, the S corporation shareholder earns a C corporation equivalent dividend of nearly $800 thousand. Assuming the RIA in this example is valued at 8x pre-tax income, the S corp shareholder experiences a distribution yield that is 180 basis points higher than if his or her RIA were structured as a C (all else equal).

The example above assumes a fully distributing RIA, since many if not most RIA clients we've encountered over the years dividend out something close to 100% of their net income. But the S corporation yield advantage also exists if, say, an RIA only distributes half of the C corp equivalent after-tax income (or, conversely, retains half of net income).

TCJA Mutes S Corp Advantage

The new tax legislation has a big impact on C corporation taxes, a more modest impact on personal income taxes, and no effect on capital gains taxes. As a consequence, the economic advantage of organizing as an S corporation or LLC has been whittled away to almost nothing in some cases, and is arguably disadvantageous in other cases.

Figure 9 on the next page depicts the comparative consequences of the new tax bill on RIAs organized as C corporations and S corporations. For C corporations, the fourteen percentage point drop in corporate tax rates improves the after-tax income available for distribution considerably. In our example, a fully distributing C corporation with $1 million in pre-tax income would have $790 thousand in after-tax income to distribute to shareholders – a substantial improvement over the $650 thousand available under the old tax rates.

For S corporations and LLCs, however, the taxes on pass-through income are still substantial, as the after-tax distribution only improves from $604 thousand to $630 thousand (yes, it still improves). If you gross this up for taxes that would be owed on the C corporation dividend, you arrive at a C corporation equivalent dividend of $827 thousand, or not much more than the $790 thousand dividend available for the C corporation. The dividend yield advantage narrows from 180 basis points before the tax legislation to 40 basis points after the tax legislation (assuming some improvement in the valuation multiple).

The comparison is even worse for investment management firms structured as tax pass-through entities but don't distribute all of their net income. Going back to the example of the firms that distribute half of their after-tax earnings (on a C corp equivalent basis), the dividend yield for the C corporation improves under the new legislation from 4.1% to 4.5%, even with a higher valuation. The S corp yield drops, however, assuming the same earnings retention as the C, from 4.6% to 3.5%, notably lower than the dollar amount and percentage distribution yield for the C corporation (Figure 10 on page 12).

> [C Corp Election] is something that we started to evaluate well before tax reform seemed imminent and we believe that our decision to elect corporate tax status is in the best interest of unitholders … Asset managers including Ares that are taxed as partnerships have historically traded at meaningful discounts to other traditional managers [which are taxed as C corps], and this is the case despite the fact that alternative managers have attractive business models that are relatively insulated from mark-to-market volatility, fee pressure, the rise of passive investing and funds with daily liquidity and outflow risk.
>
> – Mike Arougheti, CEO, Ares Management

Figure 9: Tax Treatment of S vs. C Corporations (After New Legislation)

	Full Distribution	
	C Corp	S Corp
Pre-tax Income	$1,000	$1,000
times: Valuation Multiple	8.8x	8.8x
Indicated Value (Marketable Minority Interest)	$8,800	$8,800
Pre-tax Corporate Income	$1,000	$1,000
less: Corporate Income Taxes	21.0%	0.0%
After-tax Corporate Income	$790	$1,000
Pre-tax Corporate Income		$1,000
times: QBI Deduction Percentage		0.0%
QBI Deduction		$0
Pre-tax Corporate Income		$1,000
less: QBI Deduction		-
Pre-tax Corporate Income (net)		$1,000
times: Shareholder Tax Rate		37.0%
Shareholder Pass-Through Tax Liability		$370
Portion of After-tax (C corp) Income Retained	0.0%	0.0%
Retained Earnings	$0	$0
Corporate Distributions to Shareholders	$790	$1,000
less: Shareholder Pass-Through Tax Liability		(370)
After-tax Shareholder Distribution		$630
divided by: (1 - Personal Dividend Tax Rate)		23.8%
C Corporation Equivalent Distribution		$827
C Corporation Equivalent Dividend Yield	9.0%	9.4%

Assumes state tax rate of 0%. No QBI Deduction.

Figure 10: Tax Treatment of S vs. C Corporations (After New Legislation)

	50% Distribution	
	C Corp	S Corp
Pre-tax Income	$1,000	$1,000
times: Valuation Multiple	8.8x	8.8x
Indicated Value (Marketable Minority Interest)	$8,800	$8,800
Pre-tax Corporate Income	$1,000	$1,000
less: Corporate Income Taxes	21.0%	0.0%
After-tax Corporate Income	$790	$1,000
Pre-tax Corporate Income		$1,000
times: QBI Deduction Percentage		0.0%
QBI Deduction		$0
Pre-tax Corporate Income		$1,000
less: QBI Deduction		-
Pre-tax Corporate Income (net)		$1,000
times: Shareholder Tax Rate		37.0%
Shareholder Pass-Through Tax Liability		$370
Portion of After-tax (C corp) Income Retained	50.0%	50.0%
Retained Earnings	$395	$395
Corporate Distributions to Shareholders	$395	$605
less: Shareholder Pass-Through Tax Liability		(370)
After-tax Shareholder Distribution		$235
divided by: (1 - Personal Dividend Tax Rate)		23.8%
C Corporation Equivalent Distribution		$308
C Corporation Equivalent Dividend Yield	4.5%	3.5%

Assumes state tax rate of 0%. No QBI Deduction.

(Probably) No QBI Deduction for You

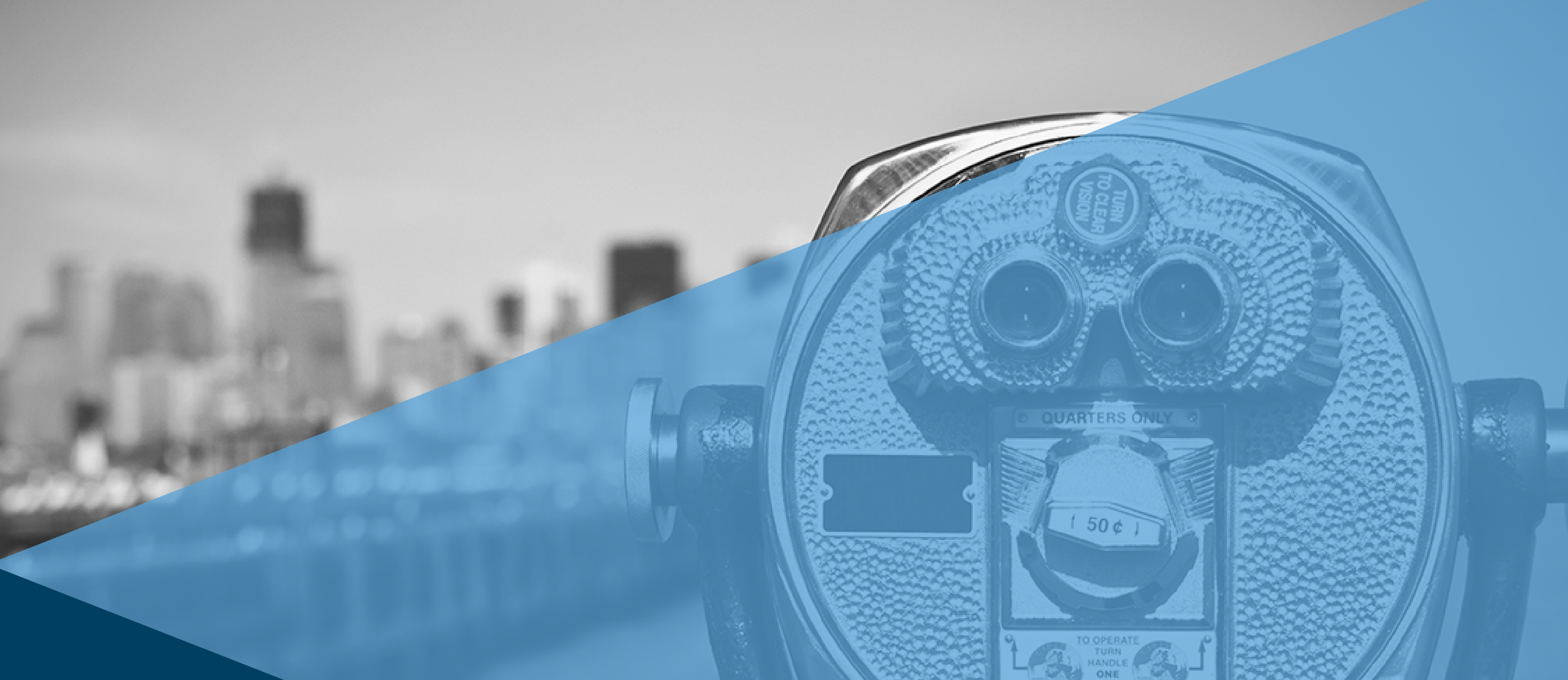
Knowing that they were trimming back the S corporation advantage, the tax bill introduced a new concept, the Qualified Business Income deduction, which allows certain S shareholders to deduct 20% of their pass-through income and, therefore, maintain more of the S corporation differential in tax rates. Unfortunately, the QBI deduction is generally not available for investment management firms.

Congress decided to exclude certain "specified service trade or business" income from qualifying for the deduction. One excluded business is investment management: "The term 'specified trade or business' means any trade or business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2))." Of note, Congress had never, to our knowledge, previously singled out investment management for specific treatment as a "specified service trade or business." Like the limitation on the deductibility of financial planning fees, it appears this administration is taking aim at the RIA community (while inexplicably allowing QBI deductions for architects and engineers). Perhaps this exclusion was an offset for failing to eliminate the carried interest deduction in the TCJA. Maybe Congress didn't feel any sympathy for an industry that has performed so well since the Financial Crisis and usually enjoys relatively high levels of compensation. Whatever the reason, it's in there, but like many features of the TCJA, it includes a loophole.

Despite the exclusion, the QBI deduction remains available to RIA shareholders for whom total income is less than $315,000 for married couples or $157,500 for individuals and is partially available for married couples and individuals up to $415,000 and $207,500, respectively. As a result, many RIA shareholders will not get the benefit of the Qualified Business Income deduction. If you find yourself in this category and do not distribute a high percentage of your earnings (that would still be subject to double taxation for C corporations), you might want to consider a C election. Otherwise, the S or LLC status probably makes the most economic sense even with the relative reduction in tax efficiency.

Even if you're at or below the income threshold, there are still a few nuances you need to consider in determining eligibility. One potential hurdle is the prohibition of "reasonable compensation" being classified as QBI, so certain RIA owners will now be incentivized to pay (or at least determine) a market rate for his or her salary and bonuses. We know firsthand that this is easier said than done and could require consultation with an industry advisor (like ourselves) or compensation expert to make such a determination. It's also important to keep in mind that the income must also be domestic and not attributable to securities investments to qualify as QBI (even though REIT income not attributable to capital gains or qualified dividends is allowable).

Regardless of eligibility, the QBI and its random countenances are not likely to be a game changer for your RIA. It is, however, worth understanding these features if you can take advantage of (one of the few) benefits from the TCJA on pass-through entities like S Corps and LLCs.



Stay Updated on How Current Events Are Affecting the Value of Your RIA

Value Focus: Asset Management Newsletter

Mercer Capital's asset management industry team produces a complimentary quarterly newsletter. Each quarter has a different sector focus and contains an industry market overview, a review of recent transactions, and tracks multiples by industry sector. To view the current issue and the archives or to subscribe to receive the quarterly newsletter, visit http://mer.cr/RIA-nl.

RIA Valuation Insights Blog

Visit Mercer Capital's blog, *RIA Valuation Insights*, for a weekly update on issues important to the asset management industry. To visit the blog or to subscribe, visit http://mer.cr/RIAInsights.

TCJA's Impact on Shareholder Agreements? Everything.

Sometimes the agreements partners enter into at the genesis of their firm don't serve them well as the firm matures. We have found this to be the case, repeatedly, with buy-sell agreements, and believe that the TCJA has rendered most shareholder agreements obsolete.

You probably don't remember signing it, much less reading it, but your buy-sell agreement is there, ostensibly, to protect your investment management firm, you, and your partners from disagreements over how to transact as owners inevitably come and go (voluntarily or not). Shareholder agreements are a big issue for most closely held businesses, but particularly for RIAs, because 1) investment management firms are often very valuable and 2) their ownership is usually made up of individuals who are otherwise unrelated (not family businesses).

The problem for most RIAs is that shareholder agreements do not have a perpetual shelf life. Firms grow, ownership structures become more complex, and needs change. Sometimes the basic economics of the firm change as a consequence of outside forces. Outdated buy-sell agreements are toxic, and – because of the recent tax bill – there are more outdated agreements today than there were a few months ago.

We aren't aware of any formal surveys of the matter, but suspect most shareholder agreements rely on some type of formula to derive buy-sell values (i.e. RIA partners agree to transact at X% of AUM, Y times revenue, or Z times EBITDA). The beauty of formula agreements is simplicity: base the agreement on a simple performance metric and it's difficult to dispute the result. The drawbacks to formula agreements are legion, however. If partners agree to transact at 2% of assets under management, it's probably because they had some expectation of how profitable the business would be, such that 2% of AUM was reasonable. Reality usually doesn't match expectations, however, and a transaction at 2% of AUM that is fair with profit margins at 25% isn't fair when profit margins are twice that (or half).

Most buy-sell agreement formulas are based on so-called rules of thumb, which are inherently problematic under the best of circumstances. Given the TCJA, many RIA rules of thumb will need revision, because most are based on pre-tax performance metrics, which are now subject to lower taxes. Prior to the TCJA, a 30% EBITDA margin might equate to, say, a 15% after-tax margin for a C corporation in a high tax state like New York or California. Post-TCJA, that same EBITDA margin could yield a 20% after-tax margin. If the firm is worth 10x net income, the tax structure that equated to a multiple of 5x EBITDA before the tax act would equate to about 7x EBITDA afterwards. This isn't to say any particular percentage increase in value is appropriate in all circumstances, but more after-tax cash flow will usually drive more value.

Rules of thumb have always had severe limitations, but with the change in tax rates, the advent of the Qualified Business Income deduction for smaller firms, a change in the market multiples for public companies, and the potential impact on sector M&A, relying on anachronistic shorthand valuation metrics has become even more risky.

We have advocated "process" buy-sell agreements for years at Mercer Capital. A process agreement is simply a set of expectations for a qualified, independent valuation professional to conduct a regular analysis of your firm to set the value as called for in your buy-sell agreement. Most of our investment management firm clients who do this have us perform the analysis annually, although the frequency of analysis can vary depending on the needs of the firm.

The downside to process agreements includes the cost of conducting the valuation analysis, both in dollars and time. The offsetting reason to commit to a regular valuation procedure is developing realistic expectations about the value of your firm, and having a thoughtful analysis that is understood, reasonable, and reliable. If having partners with an informed understanding of the value of your RIA sounds valuable to you, then you can see why firms commit to process agreements for their buy-sell.

If you were putting off reviewing your aging buy-sell agreement before the TCJA, you can't excuse waiting to review it now. If you have a process agreement, then your valuation may have a few new wrinkles this year that you'll want to study and understand. If you have a formula agreement, you probably don't know what your firm is really worth, and you need to find out.

Transactions in the Era of TCJA

One of the more interesting aspects of the TCJA is the bill's potential impact on mergers & acquisitions. Most of the press assumes that the tax bill is going to be positive for M&A, although it cuts differently across different sectors. For the investment management community, the change in tax law is a mixed bag, and we've yet to see a compelling case to suggest that, overall, it will tend to encourage or to discourage transaction activity in RIAs on a net basis. There is a case to be made that the TCJA is bullish for RIA M&A, but there is a counter-argument as well.

Point: New Tax Legislation Encourages RIA Transactions

Most commentators only see positives in the tax bill for M&A activity, and at least some of that extends to investment management firm transactions. We tend to agree, noting that rising asset prices have brought many RIAs a surge in AUM, which grows revenues similarly and profits even more, thanks to the magic of operating leverage.

> We're excited by the options created by corporate tax reform and are currently discussing how we can best serve all stakeholders. These options include committing resources to further develop our financial technologies and investment data science expertise; obviously, M&A activity; investing to optimize our global distribution efforts; and introducing and seeding new products and services. We also plan to make investments that directly benefit employees and the communities where they do business.
>
> – Greg Johnson, Chairman and CEO, Franklin Resources

For RIAs structured as C corporations, the TCJA significantly improved after-tax cash flows since most firms pay high effective tax rates. And those higher after-tax cash flows are potentially even more richly rewarded by a market willing to pay higher multiples in a time of mostly bullish sentiment.

All else equal, higher valuations usually encourage sellers to take advantage – which is important fuel to the RIA transaction community in which buyers usually outnumber sellers by a wide margin. And conglomerates with investment management firm divisions may be encouraged to make divestitures in a time when valuations are high and the taxes on gains they make in the sale would be relatively low.

All in all, there are many reasons to believe that the tax act will spur more transaction activity for RIAs. However, there is another side to this story.

Counterpoint: TCJA Does Nothing for RIA Transactions and Might Even Discourage Them

One drawback of the TCJA is that it does little, if anything, for internal RIA transactions, the most common style of investment management firm transactions. While tax rates for C corporations were slashed, the top tax rate for individuals declined modestly, from 39.6% to 37%. Most RIAs are structured as some kind of tax pass-through entity, either as an LLC or an S corporation, so taxes on most investment management firm earnings are taxed at personal rates rather than corporate rates.

Buyers in internal transactions at RIAs pay for their stock with after-tax cash flow (distributions), and, because most RIAs are structured as pass-through entities, purchasing capacity will be little improved by the TCJA (with a few exceptions). Without an improvement in after-tax distributions, internal buyers can't pay more for their stock. So the tax bill isn't really bullish for internal ownership transition. Further, to the extent that sellers now have expectations for higher prices, we may witness a widening of the bid-ask spread, which could discourage ownership transition altogether.

Final Thoughts

Few segments of the American economy are as affected by the new tax legislation as the investment management community. As the tax bill became more and more likely throughout 2017, U.S. equities soared in response to the prospect of higher after-tax cash flows, much to the benefit of asset managers. Of course, there are a number of tax bill ramifications specific to the asset management industry that are presenting new business considerations for RIAs, like the QBI exclusion and the dilution of the relative tax benefit of pass-through entities. But despite these nuances to the tax bill that appear to target the asset management industry, it appears that most RIAs have seen a net benefit from the TCJA, at least in the short term. Longer term, there are still many unknowns stemming from the TCJA, such as the impact on M&A and succession planning for asset managers, which will play out throughout 2018 and beyond.

Additional Resources

Most of the sector's recent press has focused on the tax bill's impact on RIAs, so in addition to our own whitepaper, we've highlighted some of the more salient pieces we've come across regarding the tax bill as it relates to the asset management sector.

Understanding the New Pass-Through Business Deduction for Qualified Business Income

by Michael Kitces

The *Nerd's Eye View* blog offers a great overview of the mechanics of the new QBI deduction for pass-through entities, with special attention paid to the contentious "specified service" exclusion, which prevents certain service industries (including RIAs) from realizing the full QBI deduction and drastically reduces the relative tax advantage of pass-through entities versus C corps.

Read at **mer.cr/2G6Ewvg**

Tax Overhaul Caused Slowdown in M&A: FA Insight

by Emily Zulz

RIAs were on pace for record setting M&A activity in 2017, but deal activity came to a halt in the fourth quarter as RIAs and advisors were inundated with client meetings related to the new tax bill. The slowdown is likely temporary, however, once the dust settles from the tax bill, there may be a healthy backlog of deals, and the economic impetuses for deal activity are still alive and well.

Read at **mer.cr/2IO1nNN**

The Impact of Tax Reform on Asset and Wealth Managers

by Thomas J. Holly

In the wake of recent tax reform, asset managers are reevaluating corporate structure (pass-through versus C corporation), compensation models (particularly for alternative asset managers), and firm location (a disproportionate number of asset managers are located in high income tax states and the sector is therefore disproportionately impacted by the loss of SALT deductions).

Read at **mer.cr/2uhMIgh**

How the Carried Interest Break Survived the Tax Bill

by Sahil Kapur

Despite years of being in the political crosshairs, carried interest tax breaks for hedge fund managers miraculously survived the final tax overhaul legislation.

Read at **mer.cr/2pzQ6YT**

7 New Small-Business Tax Rules You Haven't Heard Of

by William H. Byrnes

While many of the more impactful aspects of the tax bill have received plenty of press, there are several less covered (but still significant) new rules which will impact small businesses.

Read at **mer.cr/2ukyNRa**

Ares Becomes Litmus Test for Buyout Firms Mulling Tax Change

by Melissa Mittelman

Ares Management LP became the first publicly traded alternative asset manager to switch to C corporation status following the recent tax bill (with the change effective March 1). Many of Ares' peers (KKR, Blackstone, Apollo, and Carlyle Group) are still evaluating a conversion.

Read at **mer.cr/2pFodPd**

About Mercer Capital

Mercer Capital provides asset managers, independent trust companies, and financial institutions with a trust and wealth management franchise with business valuation and financial advisory services related to corporate disputes, litigated matters, and financial reporting requirements. Mercer Capital also provides transaction advisory and consulting-related services.

Mercer Capital provides a comprehensive suite of valuation and financial advisory services to meet your needs. Experience includes:

- Valuing start up managers with as little as $50 million in assets under management to established industry leaders managing over $400 billion
- Negotiating transactions involving asset managers from sell-side, buy-side, and mutually retained perspectives
- Providing financial statement reporting services related to purchase price allocation and goodwill impairment testing
- Providing expert witness testimony for purposes of marital dissolution and shareholder disputes
- Assisting RIAs and other asset managers with annual ESOP valuations, fairness opinions, and appraisals for gift and estate tax compliance

Mercer Capital's Asset Management industry group publishes research on the industry via its quarterly newsletter, *Value Focus: The Asset Management Industry*. The Group also writes about issues important to the industry on the *RIA Valuation Insights* blog.

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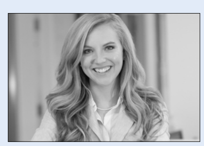

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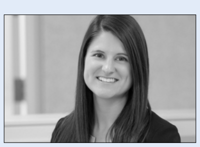

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